



# Recent Economic Developments

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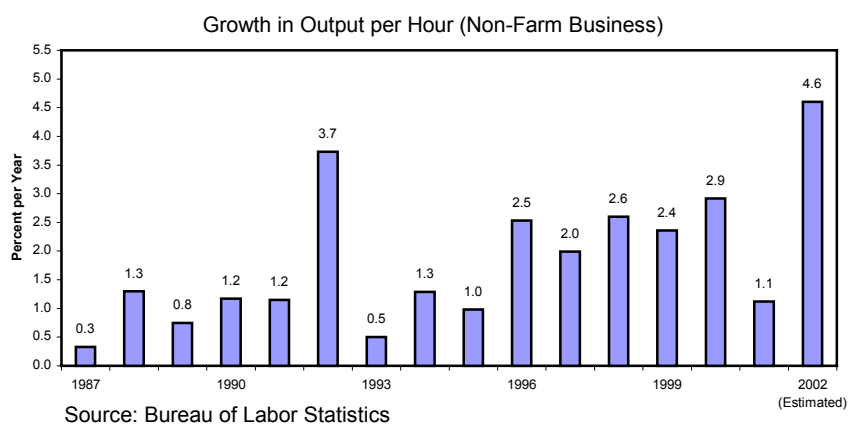
## MODERATE ECONOMIC GROWTH, BUT CONCERNS REMAIN

The economy has now been expanding for a full year at a real rate of more than three percent, despite terrorist attacks, corporate malfeasance, international tensions, and stock market declines. This remarkable resilience bodes well for future growth. Economic fundamentals point to an accelerating recovery in 2003, but some reasons for caution persist.

### Reasons for Optimism

- **Private Forecasters** are increasingly upbeat about GDP growth for the third quarter; many forecasters estimate that growth reached a 3.5 to 4.0 percent annual rate, well above earlier estimates of 2.5 to 3.0 percent. Stronger anticipated growth reflects the boom in auto sales, strength in the housing market, and reductions in the trade deficit. (The first government report on third quarter GDP will be released on October 31.)
- **GDP Growth** for the second quarter was revised up from 1.1 percent to 1.3 percent.
- **Productivity** has grown rapidly this year, confirming a trend that began in the mid-1990s. Strong productivity growth has allowed GDP to increase during the recovery despite slow employment growth.

### Strong Productivity Growth Continues



- **Long Term Interest Rates** have declined substantially in recent months. Benchmark rates on mortgages are now at six percent, and ten-year Treasury rates are below four percent, levels last seen in the 1960s. Homeowners have responded by refinancing their mortgages, lowering their monthly payments, and increasing other spending. Corporate interest rates have also fallen, which should encourage new investment.

- **Capital Spending** has been improving. New orders of nondefense capital goods, a barometer of business investment, increased significantly in July and August.
- **Household Incomes** continue to grow, helping to boost **Consumer Spending**. Consumers continue to be the main driver of the economic recovery.
- **Inflation** remains under control, giving the Fed little reason to raise interest rates.

### Reasons for Caution

- **Private Forecasters** have been lowering their estimates of fourth quarter growth; many estimates now fall in the 2.0 to 2.5 percent range, down from earlier estimates of 2.5 to 3.5 percent. These reductions reflect concern about consumer spending and, in particular, the eventual cooling off of auto sales. Growth in 2003 is expected to rebound to 3.0 percent or more.
- **Labor Markets** continue to be sluggish. Job growth has been slow, and claims for unemployment have been rising. On the other hand, some data have shown signs of improvement. The unemployment rate declined to 5.6 percent in September, after peaking at 6.0 percent in April, and mass layoffs declined significantly in August.
- **Manufacturing** has also shown some signs of weakness. After seven consecutive increases, industrial production fell slightly in August, with nearly every major component of the index declining. Capacity utilization also fell slightly in August, and an index of manufacturing activity indicated slight contraction in September. These data suggest that manufacturing activity may be stalling.
- Some firms have reported slowdowns in sales of **Consumer Goods**.
- **Household Net Worth** continues to fall; gains in home prices and bond portfolios have been more than offset by stock market declines.
- The **International Economy** is also suffering through a sluggish period. Over the last year the United States has been growing faster than many of its trading partners.
- Concerns about possible war with **Iraq** have increased oil prices and may lead to slower consumer spending and increased uncertainty in financial markets.
- **Consumer Sentiment** and **Confidence** measures have continued to decline, reflecting declines in equity wealth and a weak labor market.
- A labor dispute at **West Coast Ports** has disrupted imports and exports. Prolonged port closures could significantly damage agriculture, autos, and other industries.

### Federal Reserve Activities

- The **Federal Reserve** kept interest rates unchanged in late September, citing recent evidence that the economy is expanding at a moderate pace. The Fed sees future risks skewed toward slower economic activity; a particular concern is the potential for war with Iraq or additional terrorist acts. Two members dissented from the Fed decision, preferring an immediate rate cut to boost the economy. Although rare, such dissension is not unheard of in recent years.
- Financial markets project a significant possibility of an interest rate cut later in the year.